United States Department of Agriculture

U.S. Bureau of Agricultural Economics

and

Extension Service

Farm Bookkeeping and the Federal Income Tax

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Federal Income-Tax Requirements

1. Who must file a return?

A single person or married person not living with husband or wife, with a gross income of $500 or more.

A married person living with husband or wife, with a gross income of $1,200 or more.

A farmer counts as gross income all receipts from farm and from nonfarm sources, including the value of any merchandise received in exchange for farm products or services to others.

A return **must** be filed if the gross income reaches the specified amount even though subsequent deductions mean that no tax is due.

2. When is the return due?

For the calendar year 1942 it is due on or before March 15, 1943. For farmers using a fiscal (farm) year, not later than 2½ months after the close of the fiscal year. A "year" once established must be used for all succeeding annual returns unless special permission to make a change is obtained from the Commissioner of Internal Revenue.

3. Where and with whom must the income-tax return be filed?

With the Collector of Internal Revenue in the internal-revenue district in which the person lives or has his chief place of business. It may be filed by mail or in person.

4. What forms are needed?

The individual Income Tax Return (Form 1040) is needed by all farmers. The Schedule of Farm Income and Expenses (Form 1040F) also is required for those who report on a cash basis, and is optional for those who report on an accrual basis. Both forms can be obtained from Collectors of Internal Revenue, and usually are also available at banks, post offices, and similar places.

5. What about the Victory Tax?

It does not affect returns to be filed in 1943 as it applies only to tax years beginning after December 31, 1942. Farmers who receive income for work in industrial plants or from commercial employers during 1943 will have part of their victory tax taken currently from their wages under the withholding provisions of the law.

The purpose of this statement on Farm Bookkeeping and the Federal Income Tax is to present some of the requirements for making adequate summaries of the farm business for Federal income-tax returns and to help farmers understand some of the problems involved. This is not a set of directions for setting up a system of farm accounts, nor is it a complete set of instructions for filling out an income-tax blank. But if this statement is carefully studied and its suggestions are followed, many farmers will find they can readily arrange and summarize their business records and fill out the income-tax forms. Problems peculiar to particular situations usually can be settled best after consultation with Collectors of Internal Revenue.

Farm Bookkeeping and the Federal Income Tax [1]

Ability to summarize their financial transactions systematically is coming to be of vital importance to millions of persons as the Federal income tax dips into lower and lower income levels with higher and higher rates. Farm people are no exception. With farm income reaching new high levels and many expenses increasing as well, it is particularly important that they be able to summarize their business dealings correctly and completely.

The individual income-tax liability is a personal liability. As farmers are closer to their business than most other taxpayers, the separation of items that are personal from those that are business, as required in the law, becomes a particularly important problem. The separations must be thought through, as some of the items may be business to one person and personal to another, and may be divided in various proportions. Thus, for a farmer as an individual the "net farm profit" may be only one of the sources of income and there may be a number of personal expenditures that represent permissible deductions from his personal income. The discussion that follows is concerned primarily with those things that enter into determining the net farm profit. The references to other personal income and deductions are intended mainly to suggest a few of the reasons why records can be very helpful in the preparation of the personal items on the return.

[1] This statement has the approval of the Bureau of Internal Revenue.

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Records for Tax Purposes

Farm people have rather generally managed their affairs without formal bookkeeping, as the principal requirements of their business and personal financial relationships with others have required very few documentary records. The extension of business and industrial practices to farm operation led many farmers to study their own performance, using written records. Such records now have added usefulness as basic information for preparing income-tax returns.

Those farm people who have kept more or less formal books on their business operations, or who have systematically saved various bills and memorandums, probably will have little difficulty in preparing an income-tax return for 1942. Some system of accounts is invaluable for making and supporting income-tax returns, but the Bureau of Internal Revenue has never insisted that taxpayers keep books in any special way of its devising. An accounting system acquired now, of course, will be of no service in supplying documentary evidence in support of 1942 income-tax returns, but can be used to good advantage in assembling the items of information needed to work up the statement of 1942 income and expenses.

Farmers who have not previously reported will need to study the requirements and make decisions regarding the handling of certain items in their returns. Some of the decisions will be particularly important for those who previously have kept no formal accounts. Those who have previously reported will have made these decisions as to procedure. But under certain conditions, that will be pointed out later, they may change their methods. Obviously all those who have been reporting in previous years will need to become familiar with the changes introduced by the Revenue Act of 1942.

Basically the principles involved in setting up accounts are relatively simple. Bookkeeping for income-tax returns is more simple than that needed for an adequate study of operating performance. State and Federal agencies have account books which will serve both purposes and can help farm people in their bookkeeping. Other sets of forms also can be obtained. Some farmers may still get along without formal accounts, provided they understand the requirements for income-tax reporting and save the necessary supporting documents.

Explanations here offered are incomplete with respect to many points of practice in bookkeeping. The many transactions essentially of the same kind but differing slightly in minor details make bookkeeping seem complicated. On matters of income-tax law, and on interpretations of the prevailing regulations thereunder, many of the complications that appear result from trying to provide general rules to cover a great many different

individual situations that actually occur rather infrequently. Hence, for the most part, only the general principles have been stated for the convenience of those farm people who have usual situations. Those who have exceptional problems may need special help from Collectors of Internal Revenue, their deputies, or local people who have been instructed in the subject. But, regardless of help asked and received, the taxpayer is responsible for the facts.

Choosing the Tax Year

The first decision that must be made in connection with a summary of the farm-business transactions is the selection of a period to be covered by each report. For most farmers, a calendar year fits personal and business interests as well as any other 12-month period. Some other period, such as a crop or rental year, can be used if the taxpayer regularly keeps his accounts that way. A "tax year" once established must be used thereafter, until arrangements for a change have been made with the Commissioner of Internal Revenue. Application for a change in year, made by furnishing the information called for in Form 1128, must be made within 30 days from the end of the short period for which a report would be required to effectuate the change. A report for a short period is required because no return can cover a period of more than 12 months. For example, if permission were granted to change the tax year from one ending December 31 to one ending March 31, it would be necessary to file a report covering the 3-month period from January 1 to March 31, in the year in which the change is made. Reports made thereafter would cover 12-month periods ending on March 31 of each year.

Choosing the Accounting Method

A farmer who is just starting a set of books or one who contemplates a change in his system of handling various items will need to consider alternatives in the light of his individual business. The major choice, of course, is between determining income on a "cash" basis or on an "accrual" basis. Effective reporting requires much the same sort of records regardless of basis used in computing income. Some of the basic requirements common to both methods of reporting income, as well as some of the differences, are here pointed out to help the farmer in making his choice.

Land as a class of property needs to be kept separate. Land is not "depreciable" and gain or loss occurs only in case of sale. A gain or loss from a sale of part or all of the farm would be part of the farmer's personal financial activity and not included with the farm business. As several new provisions in the Revenue Act of 1942 affect the handling of gain or loss on real property used in the business of farming it would be well for those with specific problems to discuss them with the collector.

Buildings and improvements on land enter the annual summary under either method of accounting because depreciation may be deducted as an expense. In case of a sale the gain or loss would be treated as coming from a personal financial transaction as was the case with land.

Machinery and durable equipment is part of the capital equipment of the farm enterprise and under either method of accounting is depreciable. This depreciation is properly considered an expense incurred in the production process. Should any such items be sold the gain or loss is mingled with those from other transactions completed in the regular course of business. For income purposes this gain or loss can be looked at as an adjustment for over- or under-depreciation in previous years.

Under the cash method purchased animals must be treated as capital items, the same as machinery and durable equipment, if depreciation is to be claimed. Under the accrual method work animals and breeding and dairy stock may be treated either as capital items, or as inventory items along with other crops or produce for sale. If treated as capital items, depreciation can be claimed as in the case of machinery. If treated as inventory items depreciation as such is not claimable but changes in value between the beginning and the end of the year are reflected in the inventories.

A record of receipts and disbursements is necessary for both cash and accrual reporting. By definition, under the cash method receipts or disbursements apply in the year when the cash was received or was disbursed. Under the accrual method the date of cash settlement is of no special significance in the assignment of income or expense to a particular year. An inventory of crops and livestock is needed for reporting income on an accrual basis.

A reconsideration of the problems peculiar to his business may lead a farmer to the conclusion that it would be desirable to change the accounting method which has been followed in making income-tax returns in the past. This can be done by making application for permission to the Commissioner of Internal Revenue. The application must be filed within 90 days after the beginning of the first taxable year to be affected by the change. In order to effectuate a change adjustments must be made on a basis that will satisfy the Commissioner that income has been properly reflected without prejudice to taxes properly due. The extent of the adjustment necessary will vary with individual situations and is essentially a matter for negotiation with the Commissioner.

The Victory Tax

The victory tax does not affect farmers so far as returns to be made in 1943 are concerned. It will apply only to tax years beginning after December 31, 1942. On returns to

be filed in 1944 a victory tax of 5 percent will be computed on "victory tax net income." A post-war credit or refund amounting to 25 percent of the victory tax for single persons and 40 percent for married persons plus an allowance for dependents is provided for in the law. The amount actually paid in 1944 can be reduced if this post-war credit is absorbed by credits allowed for payments for life insurance, debt reduction, or war bonds. The collection of the tax at source on wages which begins on January 1, 1943, also will not be of interest to farmers except as they may be employed off the farm by industrial or commercial employers who are required to withhold the tax from wages earned by their employees. It should be noted that farmers need not withhold the tax from payments to their hired help as wages paid to agricultural labor are specifically exempt from the withholding provisions.

The victory tax serves to emphasize the fact that the individual income-tax liability is a personal liability. The farm enterprise has no income-tax liability as such except in the rare case of incorporation. The "net farm profit" which the owner or operator receives is subject to tax as his personal income. The victory tax emphasizes the need for clearly differentiating personal and business transactions somewhere in the summaries of the year's financial operations.

The "victory tax net income" for farmers who are without income from nonfarm sources will be essentially the net profit from farm operations. It will be larger than the net income used in computing the regular income tax because the various personal items, such as contributions, personal taxes, interest on personal debt, and the like, are not deductible. For the victory tax only those deductions that appear in the farm-business summary are deductible. Thus it becomes important to keep separate in the accounts those items which are personal and those which are business. It is particularly desirable to give attention to disbursements that must be divided between the two classes. One example of a disbursement partly in each class is the property tax on the farm. This must be divided to show the part applicable to the farm residence and nonbusiness personal property, and that applicable to the land, farm buildings, and other production facilities. Other examples are mentioned in the detailed discussion of items entering into income and expense.

Farm Income

Farm income for tax purposes when determined on a "cash" basis is the sum of four groups of items: (1) The amount of the cash or the value of merchandise or other property received from the sale of livestock which was raised during the taxable year or prior years, (2) the same for crops and produce raised and sold, (3) the profits from the sale of any live-

stock or other items which were purchased, and (4) other farm income. When income is determined on an "accrual" basis, inventory change must be taken into account.

Income from livestock raised:

For livestock raised on the farm, "income" on a cash basis is the total receipts from the sale of the livestock. If livestock is traded for merchandise or other property the income reported must include the value of the property received in exchange. On Form 1040F the number or quantities sold and the income from each item are to be shown. The entire sale value of animals raised on the farm is "income" in the year of sale; the value added during the year to animals not sold is not counted. On the accrual basis the income sought to be taxed is the difference between the sale price and the costs incurred over the entire period of growth. This is accomplished by using inventories. Because of the difficulty of ascertaining actual costs for inventory purposes, farmers may use the "farm price method" which provides for the valuation of inventories at market price less direct costs of disposition. Those with inventory problems peculiar to their operations will do well to consult the collector.

Income from crops and produce raised:

The procedure for reporting income from crops and produce (including livestock, dairy, and poultry products) raised is similar to that for livestock. Quantities and cash receipts (or value of goods received in exchange) are entered separately for each class of item. If crops are stored on the farm beyond the end of the year (or fiscal period) during which they are raised, all the income falls in the year when the crop is sold when reporting on a cash basis, but only the difference between the amount received and the expense of raising such crop falls in the year of sale when reporting on an accrual basis.

If a loan is obtained from the Commodity Credit Corporation the farmer may elect to include it in his income in the year in which the loan is received instead of in the year when the commodity is finally sold. Whichever method is elected must be followed in succeeding years unless special permission to make a change is obtained from the Commissioner. A new provision in the Revenue Act of 1942 permits this election to be exercised with respect to fiscal years beginning after December 31, 1938, at or before the time of filing the 1942 return. But the records of the taxpayer must be sufficient to permit accurate recomputation of income for each of the earlier years affected and the taxpayer must consent to deficiency assessment of taxes for such years should the recomputation show them to be due.

Profits from the sale of livestock or products purchased:

To arrive at the profit figure to be included in income, Form 1040F calls for the following information in addition to the description of the animal or product: (1) The date acquired, (2) the sale price, (3) the cost, (4) the depreciation allowed or allowable for previous years, and (5) the profit. The profit is the amount of the excess of the sales price over the amount representing the depreciated cost; that is, the original cost minus the depreciation allowed (but not less than the amount allowable) since acquisition. If some of the livestock marketed from the farm were *raised* and some previously *purchased* it may be desirable to discuss with the collector the questions involved in seregating the two groups. Individual identification may perhaps be waived for small animals like chickens and lambs, and not waived in the case of animals of high value.

Another question that may need to be discussed with the collector is the matter of a depreciation method. This is important not only in the case of breeding and dairy animals and the like, which were purchased and later sold, but also in the case of draft animals and property in general as mentioned later.

Other farm income:

Values, or amounts, are to be reported for any other items of income arising from the farm business. Included are such income items as payments from the AAA, merchandise received for produce, machine work, hire of teams, breeding fees, rent received in crop shares, work off farm, forest products, and any other like receipts. In general, anything of value received instead of cash must be treated as income to the extent of its market value.

Hail or fire insurance for growing crops that were injured or destroyed should be included in gross income to the extent of the amount received in cash or the cash equivalent if received in kind.

The value of home-grown farm produce that is consumed by the farmer and his family need not be reported as income, but expenses incurred in raising produce thus consumed must not be claimed as deductions. Separating such expense items may cause some difficulty but a reasonable estimate should be made if the produce consumed on the farm is not reported as income. If it is reported as income no segregation of expense items is necessary on that account.

Earnings from personal services of minors should be included with the income of the parent for income-tax purposes unless under the laws of the State earnings of a minor belong to the minor.

"Other Farm Income" does not include any receipts arising from the sale of the farm or any part of it. Such transactions are con-

sidered not part of the farm business, but personal, and are taken care of directly on Form 1040.

Farm Expenses

A proper record of the farm expenses is fully as significant to a farmer as the record of his income. Deductions are often difficult to establish unless one has a record. Many payments are made in relatively small amounts on numerous occasions. If they have been systematically recorded, preparing entries for Form 1040F is reduced to classifying and totaling. In general, disbursements necessary in the production operations of the farm are allowable deductions in arriving at the net farm profit. Expenses are counted in the year in which payment is made in reporting on a cash basis. In reporting on an accrual basis, expenses are counted in the year in which incurred, whether paid or not. Depreciation allowances are to be taken each year as "expenses."

Labor hired:

Wages paid for farm work done are included, but no allowance for the value of the work of the farmer, his wife, or dependent minor children is deductible unless the amount deducted is reported as income. Board furnished to hired labor is deductible only to the extent that it is purchased by the farmer or his family, thus excluding the value of food raised on the farm and used in boarding laborers. The value of rations purchased and furnished to laborers and sharecroppers is deductible as part of the labor expense. Hired household work is deductible only to the extent that the services are used in boarding or otherwise caring for farm laborers, not including the farmer's own household.

Production supplies:

Amounts expended for feed, seed, fertilizers, lime, manure, and all similar supplies purchased and used in the production of crops and livestock are deductible expense items. The value of seed, feed, and manure produced and used on the farm is not deductible.

Taxes:

In general, most State and local taxes are deductible either on Form 1040F as items of farm expense or on Form 1040 as personal taxes paid by the farmer. Property taxes on the farm land, machinery, livestock, and other production items are deductible as farm expenses. The portion of the property tax that applies to the dwelling, and household or personal effects, is a *personal*, not a *business* expense, and is entered directly on Form 1040. This distinction will be more important in 1944 when the return will include a computation of victory-tax liability on 1943 income. Special taxes and assessments such as levee, drainage, and certain irrigation taxes are **not** deductible

if they tend to increase the value of the property assessed. Federal income taxes, estate, inheritance, and similar taxes also are not deductible. Taxes such as those on retail-sales applying to items used in the farm business may be considered as part of the cost of the items. Taxes on gasoline used in operating vehicles as part of the farm business operations are deductible as business expenses. State and local retail-sales taxes paid in connection with the farmer's personal and family expenditures are deductible under the Revenue Act of 1942 whenever the tax has been separately stated, and paid by the purchaser. In any event some sort of record is essential to make it possible easily to substantiate such claims.

Insurance:

Insurance paid in connection with farm operations is deductible. This will include all fire and similar insurance on buildings, machinery, and crops, but not insurance on the farm dwelling or personal and household effects.

Interest:

Interest paid on obligations, such as mortgages and notes, arising out of the farm business may be deducted as a business expense. Most other interest paid is a personal item and is entered directly on Form 1040.

Rent:

Rent paid in cash is deductible, but rent paid in the form of crops is not deductible, although the expenses incurred in raising the crops may be deducted.

Tools, machinery, and equipment:

The cost of small tools and items of short life used in the business may be deducted as expenses. Automobile operating expenses, repairs and maintenance, and depreciation may be deducted if the vehicle is used entirely for the farm business but if the vehicle is also used for personal travel, the expense must be divided and only that portion corresponding to the relative use in the business is deductible as an expense. The amounts expended for automobiles, farm machinery, farm buildings, and other equipment of a permanent nature are not deductible as expenses, because such expenditures are regarded as investment of capital which is returned to the owner through depreciation allowances prorated over the useful life of the property.

Depreciation:

Depreciation is a deduction from gross profits which is considered to represent that part of the particular item that was used up in producing the income for the year. A reasonable allowance for depreciation with respect to farm buildings (except the farmer's own dwelling), farm machinery, automobiles (in proportion to their use strictly for farm operations), and

other physical property may be deducted. There may also be deducted a reasonable allowance for depreciation of livestock acquired for work, breeding, or dairy purposes, if the animals are carried in a "capital" account. If the animals are carried in the "inventory" no depreciation can be claimed as a separate item.

The amount of depreciation in a given year depends upon the "useful life of the property." The period of usefulness varies greatly among different kinds of property. The taxpayer may establish his own tentative plan of depreciation allowances, but after it is accepted by the Bureau of Internal Revenue he will be expected to use this plan for the entire period of useful life of the item for which it was established. Thus, it often will be advisable for the individual farmer to discuss his depreciation problem with the collector.

Preparing the list of depreciable property and establishing the depreciation rates require especial care in connection with the first return filed because the same rates are expected to be used throughout the life of the item. In order to have a basis for considering the depreciation allowable for given items the farmer will need to supply the following information for each item:

(1) Kind of property.
(2) Date acquired.
(3) Cost.
(4) Estimated total useful life.
(5) Remaining useful life.
(6) Depreciation allowed (or allowable) in prior years.
(7) Remaining cost to be recovered.
(8) Depreciation allowable this year.

For any farmer's full list of property the depreciation sum may vary from year to year, depending on when and how many items are added or disposed of during the year.

The sum of the expense and depreciation items constitutes the deduction from gross profits for arriving at a figure for net farm profit. This net-farm-profit figure is entered on Form 1040 as the farmer's personal income from his farm operations.

Nonfarm Receipts and Expenditures

The desirability of records of nonfarm *personal and family* receipts and expenditures, as distinct from farm *business* records, often is overlooked. For many farm people the personal items are so small or so scattered through the year that they may be difficult to recall or to substantiate unless some systematically kept record is available. Where the items are large it may be even more important to have a record.

One item of personal income that will mean more to many farmers now than in the past is compensation for work done off the farm. This will be a substantial sum for many who have been working in industrial or commercial establishments for extended periods. Other items of personal income that must be reported

include interest on savings accounts, dividends on investments, and other miscellaneous kinds of income. Earnings from personal services of minor children must be included with the income of the parents for tax purposes unless under the laws of the State the earnings of the minor belong to the minor. If a minor has income of his own from property in his own name or held in trust for him, a separate return must be filed if he has gross income of $500 or more, if single, or $1,200 or more, if married.

Gains or losses arising from the sale or exchange of "capital assets" must be shown on the return. Gain or loss from a "capital asset" receives special treatment depending on the period during which it was held. Under the new law, 100 percent of the gain or loss must be reported if the capital asset has been held for 6 months or less. Only 50 percent of the gain or loss is taken into account if the capital asset has been held for more than 6 months. Under the Revenue Act of 1942 any profit or loss from the sale of depreciable property and land used in the trade or business of the taxpayer and held more than 6 months is given special treatment. Thus if all or part of the farm has been sold it would be well to discuss with the collector the question of handling the gain or loss.

Expenditure items of a personal nature for which a record is highly desirable probably are more numerous than the income items. The general rule is that an individual may not deduct personal, living, or family expenses except certain extraordinary medical expenses. But certain items can be deducted if their amount can be established. A few have been mentioned in connection with similar business items. One example relates to taxes paid. As was pointed out, that part of the property tax that is applicable to the farm residence or nonfarm personal property is a deductible personal expense. State and local retail sales taxes on personal and family-living items are deductible to the extent that they are separately stated and paid by the purchaser. Federal taxes which may be deducted are those on admissions, club dues, telephone and telegraph services, safe deposit boxes, transportation of persons and property, use of motor vehicle or boat, and documents. In no case should a tax expenditure be claimed as a personal deduction if it already has been included in business expenses.

Contributions and gifts to charitable, religious, educational, and certain other organizations are deductible within certain limits. Contributions to community chests, war funds, churches, American Red Cross, United Service Organizations, Boy and Girl Scouts, and similar groups are among those which may be deducted, but the total deduction is limited to 15 percent of the net income computed without the benefit of such deduction.

Amounts paid as interest on indebtedness not connected with the farm business are deductible, except where the indebtedness arises in

connection with the purchase of certain tax-exempt securities; also deductible are losses on bad debts.

The deductibility of certain extraordinary medical and dental expenses is provided for by a new provision in the Revenue Act of 1942. Medical care is defined in the law to include "amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance)." There may be deducted from net income as much of such expenses as exceeds 5 percent of net income, with a maximum deduction of $2,500 for a joint return of husband and wife or return of the head of a family, and $1,250 for other individuals.

Personal net income then is the sum of the personal-income items, including the net profit from farming, minus the sum of the permitted personal deductions. The graduated surtaxes, beginning with 13 percent, apply to net income minus the personal exemption and credit for dependents. The normal tax of 6 percent applies to the net income reduced by the personal exemption, the credit for dependents, the earned-income credit, and the amount of interest on certain United States obligations.

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It is clear that a written record of receipts and expenditures is highly important to a farmer when he is preparing his income-tax returns. It is intended that a taxpayer's regular accounts, files of receipts, and records of whatever kind, shall be sufficient for filing income-tax returns. Generally, any record that suits the taxpayer's needs will serve the tax collector, provided that effective information is available and the taxpayer is prepared to prove the essential reality of claims or statements made. Books as such are not final proof of anything, but in connection with material evidence which the book entries may properly describe, account books are worth the trouble. The usefulness of account keeping, moreover, extends far beyond any single purpose such as income-tax reporting. The analysis of the farm business required in order to decide which is the best of several alternatives as to taxable year, method of determining income, depreciation rates, etc., naturally leads into the use of the records for guidance on questions of farm management. Better farming, and farmers better off, will be the logical result as farm accounts are used to analyze the financial results of farm operations.

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